

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Public Markets Committee Meeting
Minutes

July 1, 2003

The Public Markets Committee met in open public session at 9:00 A.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive Southwest, Olympia, Washington.

Members Present: Charles Kaminski, Chair
Debbie Brookman
Glenn Gorton
Jeff Hanna
Patrick McElligott
Robert Nakahara
Representative Sommers

Other Board Members Present: George Masten
John Magnuson

Others Present: Joe Dear
Gary Bruebaker
Nancy Calkins
Linda Lester
Diana Will
Tom Bosworth
Liz Mendizabal
Kristi Bromley

Paul Silver, Assistant Attorney General

Janet Becker-Wold, Callan Associates
Michael O'Leary, Callan Associates

The meeting convened at 9:00 A.M. with Chair Kaminski identifying members present.

REVIEW AND APPROVAL OF MINUTES – JUNE 3, 2003

Mr. McElligott moved to adopt the minutes of June 3, 2003.

Ms. Brookman seconded and the motion carried unanimously.

FIXED INCOME – LABOR AND INDUSTRIES' INSURANCE FUNDS POLICY 2.20.100 REVISION

Mr. Bruebaker said staff has been working closely with the consultant for the Labor and Industries' funds, Conning Asset Management Company (Conning), and Labor and Industries' staff on some issues related to the Labor and Industries' Funds Policy 2.20.100. The duration calculation for the Accident Fund does not take into account the equities that are held in that Fund. Staff believes effective management of the fund requires the ability to be more than 20 percent short the duration target of the liabilities, given the effect of the current interest-rate environment and that there is not a duration for equities. He said that Conning would be conducting an asset liability study in the fall at which time staff will discuss any changes to the current policy with the Board.

Discussion ensued regarding the modeling of the liabilities, contingency reserve, and if this had any affect on the contribution rate paid by employers, which it does not.

Mr. McElligott moved that the Public Markets Committee recommend that the Board authorize the WSIB to be more than 20 percent short the duration target of the liabilities, notwithstanding WSIB policy 2.20.100, for the Accident Fund until such time as the asset liability study is completed. Ms. Brookman seconded and the motion carried unanimously.

[Representative Sommers was in attendance at 9:09 A.M.]

PUBLIC EQUITY – EDUCATIONAL SESSION – CURRENCY MANAGEMENT

Mr. Bruebaker noted it was the current policy of the WSIB to take a long-term view of currency management with the belief that currency management is, in the most part, a zero sum gain with costs greater than or equal to benefits derived from a currency overlay program. He noted the individual active international developed markets managers are allowed to do currency hedging as part of their investment discretion.

Ms. Becker-Wold and Mr. O'Leary, Callan Associates (Callan), introduced themselves. Ms. Becker-Wold addressed the follow-up question from the June 3, 2003, Public Markets Committee meeting regarding the persistence of the outperformance of value managers. She reviewed charts showing the outperformance of value over the long-term using both the Citibank and the Morgan Stanley style indices. Theories for value's outperformance include an efficient market view and a behavior view. She noted the persistence of value investing is consistent for domestic and international markets.

Ms. Becker-Wold presented the educational session on currency management. She reviewed the effect of currency on returns for periods from one- to 20-years, noting that over the very long run currency returns appear to be zero sum but those returns can be positive or negative for an extended period of time. She reviewed other charts showing the contribution of currency to the returns of the Europe, Austria, and Far East index. She said hedging is a tradeoff between a known return and an unknown return and reviewed the effects of currency movements on market value of securities.

Ms. Becker-Wold reviewed the levels of currency risk and currency's contribution to total fund risk. She noted currency could dampen risk since it is not positively correlated to any asset class. She reviewed types of currency management and the objectives of currency hedging and currency hedging benchmarks.

Implementation options were discussed including active/passive and internal/external. Mr. O'Leary noted that most of Callan's clients have placed hedging externally with their active managers on an opportunistic basis and said funds with large active international components were less likely to hedge since hedging was almost betting against their own managers. Further discussion ensued regarding benchmark selection, lack of persistency of specialty managers to add value in this area, the natural hedge inherent in stock investing, and the diversification of dollar based and non-dollar based assets. It was noted that neither Callan nor staff are recommending currency overlay as part of the structure of the international equity program.

PUBLIC EQUITY – INTERNATIONAL PROGRAM STRUCTURE

Mr. Bruebaker reviewed the educational sessions presented to the Committee as part of the international program structure review: transition management, the outlook for international markets, gaining emerging markets exposure in a diversified retirement fund, growth versus value investing, active versus passive investing, capitalization, and currency management. He said Callan would present their international equity structure report and their specific recommendations and staff would follow with their specific recommendations. He noted the most important decision had already been made, the 15 percent allocation to international equity, and there was not a single right answer to determining the various international equity exposures.

Ms. Becker-Wold said Callan's International Equities Structure report pulls together all the pieces the Committee has reviewed over the past five months and summarizes the issues that led Callan to their recommendation. She reviewed two alternatives to the current WSIB international equity program structure. Both structures maintained exposure to emerging markets at ten percent and had varying allocations to active and passive strategies. Discussion took place pertaining to Callan's proposed value and growth weightings, passive and active investing, the importance of sticking to a policy decision, and the benefits of international investing. Discussion also continued regarding emerging markets exposure and Callan's recommendation for a strategic allocation to emerging markets.

[The Committee recessed at 10:32 A.M. and reconvened at 10:41 A.M.]

Mr. Bruebaker reviewed the WSIB's current international equity structure. He presented staff's recommended international equity program structure: allocate 100 percent of the international program to developed markets (active managers able to invest up to 15 percent opportunistically in emerging markets - up from 10 percent in the current structure) and increase active management from 50 percent to 60 percent (40 percent of that allocated to core, 30 percent to growth, and 30 percent to value). He noted staff did not recommend a specific allocation to small cap, but active managers would have the ability to invest opportunistically in small cap up to ten percent (same as current structure). Discussion ensued regarding the increased allocation to active core. Mr. Bruebaker noted, with the Committee's permission, staff would like to structure the passive international Request for Proposal (RFP) to allow up to half of the allocation to passive investing to be in an enhanced structure. He noted experience historically shows that enhanced indexing consistently adds a small amount of value and discussion ensued regarding enhanced indexing.

The Committee, Callan, and staff discussed in detail the various components of the recommendations including the allocation to emerging markets; the weightings to core, growth, and value; and the allocations to active and passive strategies in the developed markets, including possible exposure to enhanced indexing. Also discussed were the costs associated with manager transitions.

Mr. McElligott moved that the Public Markets Committee recommend that the Board adopt the following international equity structure:

- **Allocate 7.5 percent of the international allocation to emerging markets with 100 percent to active management.**
- **Allocate 92.5 percent of the international allocation to developed markets with 60 percent of that allocated to active management and 40 percent allocated to passive management.**
- **Of the 60 percent allocation to developed markets active management allocate 40 percent to core, 30 percent to growth, and 30 percent to value.**
- **Allow the developed markets active managers to invest up to 15 percent in emerging markets and up to 10 percent in small cap on an opportunistic basis.**
- **Of the 40 percent allocation to developed markets passive management, WSIB staff will issue an RFP that would allow up to 50 percent of the allocation to be managed within an enhanced passive strategy but that would also allow the Board to select all passive management.**

Representative Sommers seconded and the motion carried unanimously.

[The Committee recessed for lunch at 11:50 A.M. and reconvened at 12:13 P.M.]

[Representative Sommers was no longer in attendance at 12:13 P.M.]

Mr. Bruebaker summarized the Committee's action and noted the recommendation of a 7.5 percent allocation to emerging markets, in conjunction with the developed markets active managers' ability to opportunistically invest in emerging markets, does not allow the Board to be underweight in emerging markets. A strategic allocation to emerging markets of five percent would provide the opportunity for the fund to be underweight emerging markets. Discussion ensued regarding the benefit of having the dedicated emerging markets allocation lower than the current weight of emerging markets in the index.

Mr. McElligott moved that the dedicated emerging markets allocation for the international equity program approved by the earlier motion be reduced from 7.5 percent to 5 percent with 100 percent of that allocated to active management; and the allocation to developed markets increased from 92.5 percent to 95 percent accordingly. Ms. Brookman seconded and the motion carried unanimously.

PUBLIC EQUITY – TRANSITION MANAGEMENT SERVICE PROVIDERS

Mr. Bruebaker noted the Board could receive transition services under the existing contracts with Barclays Global Investors and State Street Global Advisors. He said a specialty transition service provider might add value on a transition involving active managers.

Mr. McElligott moved that the Public Markets Committee recommend that the Board authorize the Executive Director to work with one of the Board's consultants to issue a Request for Proposals to select one or more transition service providers to assist the WSIB with transitions, as appropriate. Mr. Gorton seconded and the motion carried unanimously.

PUBLIC EQUITY – BENCHMARK REVIEW UPDATE

Mr. Bruebaker reported there was no new information at this time. It was noted the Morgan Stanley Capital International benchmark changes were taking longer than anticipated and the marketplace likes the improvements made to the Wilshire benchmark.

OTHER ITEMS

Mr. Bruebaker reported that July 1 was the effective date for the transition to the new socially responsible investment manager and the new money market accounts.

There being no further business to come before the Public Markets Committee, the meeting adjourned at 12:26 P.M.